

# Magellan Global Equities Fund (Currency Hedged) (Managed Fund)

ARSN: 606 840 206

ASX code: MHG

## Fund Facts

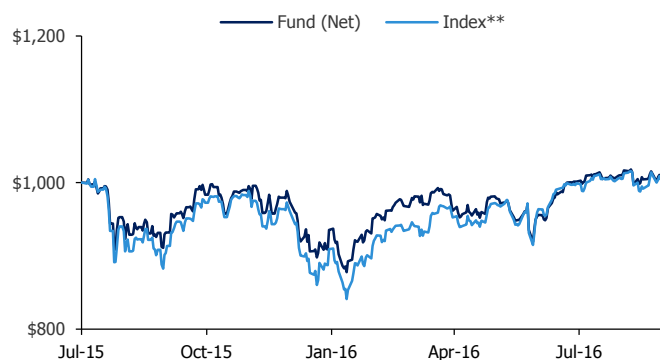
|  |   |                                    |  |
|--|---|------------------------------------|--|
| Portfolio Manager                            | Hamish Douglass   |                                    |  |
| Structure                                    | ASX-quoted Global Equities Fund, \$AUD Hedged   |                                    |  |
| Inception Date                               | 4 August 2015   |                                    |  |
| Management & Administration Fee <sup>1</sup> | 1.35% per annum   |                                    |  |
| Fund Size                                    | AUD \$35.7 million  |                                    |  |
| Distribution Frequency                       | Annually at 30 June   |                                    |  |
| Performance Fee <sup>1</sup>                 | 10.0% of the excess return over the higher of the Index Relative Hurdle (MSCI World Net Total Return Index (hedged to AUD)) and the Absolute Return Hurdle (the yield of 10-year Australian Government Bonds). Additionally, the Performance Fees are subject to a high water mark. |                                    |  |
| iNAV tickers                                 | Bloomberg<br>Thomson Reuters<br>IRESS   | MHG AU Equity<br>MHG.AX<br>MHG.AXW | MHGIV Index<br>MHGn.IDOC<br>MHGNAV.ETF |

<sup>1</sup>All fees are inclusive of the net effect of GST

## Fund Features

- Currency hedged version of the ASX-quoted Magellan Global Equities Fund
- Fund is actively managed
- Minimum administration for investors; no paperwork needed to trade
- Units can be bought or sold on the ASX like any other listed security
- Efficient and live pricing
- Provision of liquidity by the Fund
- Settlement via CHES
- Magellan has significant investment alongside unit holders.

## Performance Chart growth of AUD \$1,000\*



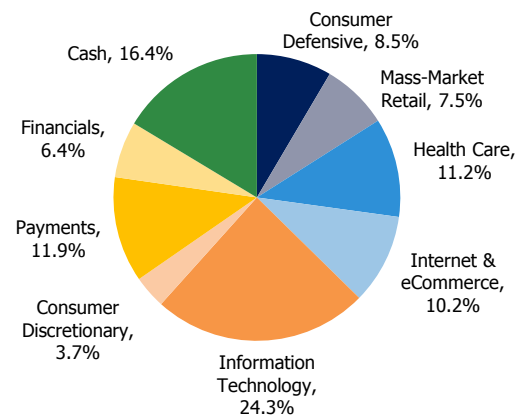
## Fund Performance\*

|                          | Fund (%) | Index (%)** | Excess (%) |
|--------------------------|----------|-------------|------------|
| 1 Month                  | 0.2      | 0.3         | -0.1       |
| 3 Months                 | 6.1      | 5.1         | 1.0        |
| 6 Months                 | 3.6      | 6.9         | -3.3       |
| 1 Year                   | 8.9      | 11.8        | -2.9       |
| Since Inception (% p.a.) | 1.0      | 0.7         | 0.3        |

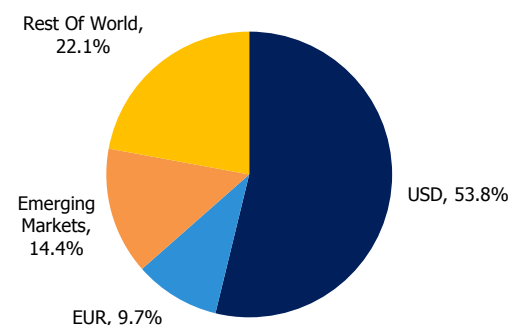
## Top 10 Holdings

|                     | Magellan Defined Sector | %           |
|---------------------|-------------------------|-------------|
| Apple Inc           | Information Technology  | 6.5         |
| eBay Inc            | Internet & eCommerce    | 5.3         |
| Visa Inc            | Payments                | 5.1         |
| Alphabet Inc        | Internet & eCommerce    | 4.9         |
| Yum! Brands Inc     | Consumer Defensive      | 4.9         |
| Microsoft Corp      | Information Technology  | 4.7         |
| Intel Corp          | Information Technology  | 4.4         |
| Oracle Corp         | Information Technology  | 4.1         |
| PayPal Holdings Inc | Payments                | 4.0         |
| Lowe's Co Inc       | Consumer Discretionary  | 3.7         |
| <b>TOTAL:</b>       |                         | <b>47.6</b> |

## Industry Exposure by Source of Revenues<sup>#</sup>



## Geographical Exposure by Source of Revenues<sup>#</sup>



\* Calculations are based on the monthly ASX released net asset value with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Fund Inception 4 August 2015. Returns denoted in AUD.

\*\* MSCI World Net Total Return Index (hedged to AUD)

# Calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio - Magellan defined sectors.

## Market Commentary

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Comments from central bankers remained in focus, particularly the US Federal Reserve which released updated projections for the Federal Funds rate, suggesting a further extension in its policy normalisation timeline. Meanwhile, in response to risks associated with Brexit, the Bank of England cut the Bank Rate for the first time since the global financial crisis and announced a new round of Quantitative Easing along with a £100 billion term funding scheme to lower funding costs for banks.

Interest in the US presidential campaign gathered momentum, as investors increased speculation over policy and associated implications for markets and the US economy. Political risks in the euro zone remained elevated, in particular in Italy where the upcoming Constitutional Referendum and capital shortfalls at Italian banks added to uncertainty.

The US economy's trajectory of steady growth continued during the quarter, evidenced by growing personal consumption expenditures, rising consumer sentiment and an improvement in labour market conditions. Economic data in the UK stabilised during the quarter, exceeding expectations, while continental Europe's gradual recovery appeared little affected by the Brexit vote. In China, the ongoing economic slowdown was temporarily alleviated by a bout of rapid, credit-fuelled growth in China's property market.

We remain cautious about the outlook for equity markets, and retain exposure to high quality companies together with a large weight in cash to preserve capital.

## Fund Commentary

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As of 30 September 2016, the Fund consisted of investments in 25 companies, compared with 24 companies held as at 30 June 2016. The top ten investments represented 47.6% of the Fund on 30 September 2016, while they represented 46.6% of the Fund as at 30 June 2016. The cash position was broadly unchanged from the prior quarter at 16.4% as at 30 September 2016.

The Fund outperformed the benchmark in the September quarter, driven by strong contributions from many of its largest positions. The largest contributor to performance this quarter was eBay. The company's stock price rose strongly in July following its latest earnings release which was favourably received by the market. The company exceeded consensus expectations for revenue and earnings per share growth, showing a sequential improvement in US Gross Merchandise Value growth in the quarter. Apple also performed well following the release of its quarterly results and received a further boost following the release of its latest iPhone 7 product in September. Intel performed strongly through the quarter, primarily due to improving sentiment around the outlook for the PC market (the PC segment constitutes a majority of Intel's revenue). The company formally increased its guidance for third-quarter revenue growth in September, citing channel inventory build and early signs of improving end-user demand.

The major detractors from performance were positions in Lowe's, Sanofi and CVS Health. Lowe's was weak following its second quarter earnings release, with its comparable sales growth slowing to 2%. However, the company maintained full-year guidance of 4% and reiterated confidence in growth improving in the second half of 2016. Sanofi declined following the surprise exclusion of its key insulin product, Lantus, from CVS and UnitedHealth's formularies and after losing to Pfizer in the bidding war for Medivation.

CVS Health's share price declined through the latter part of the quarter due to weakening sentiment around regulatory risks which were exacerbated by the US election cycle and the heightened public scrutiny following Mylan Pharmaceutical's EpiPen pricing scandal.

Lloyds Banking Group was a significant detractor from performance this quarter, largely due to the Brexit outcome which impacted UK focused companies. We do not foresee any direct operational implications for Lloyds, although a likely slowdown in UK economic activity will pose challenges for the Bank. The exact economic impact of the Brexit vote will remain unclear for some time and downward pressure is likely to remain on interest rates with heightened risks for the British pound. Lloyds is well placed to meet these challenges, reflecting its significant restructuring post the financial crisis into a retail focused bank with a simple, relatively low risk, business model. Following the recent sell-off, Lloyds' is trading at a material discount to our assessment of its long-term intrinsic value, notwithstanding its near-term challenges.

## Key Stock in Focus - Alphabet

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### Alphabet

Google was formed by two Stanford PhD students in 1998 using an innovative technique to rank websites for relevancy in the early growth phase of the internet. It has since grown into the largest advertising company in the world, driven by the mission to organise the world's information and make it universally accessible and useful.

Alphabet, the parent entity of Google, is a highly innovative company with an incredibly valuable and dominant search business which continues to grow strongly and generate substantial free cash flow. This has enabled it to invest in new, often radical, products and services with a long-term view to building leading positions in potentially massive markets.

### Leader in search and mobile

Alphabet's primary business is Google Search, which represents around three-quarters of its total sales and an even higher proportion of its earnings. Google's Search is a highly effective, measurable and scalable form of advertising, which has grown from next to nothing in 2000 to around 15% of global media advertising spending in 2015.

We estimate Google has over 80% share of the global search market (ex-China). The economics of Search favour the market leader, given significant fixed-cost hardware and software investments and the virtuous cycle of greater usage. More user data (what a user does, and does not, click through) allows the incumbent to test changes, iterate and improve search results faster and more effectively than competitors. Google's strong brand and continually improving product has stymied competitors' attempts to attract users away. Microsoft's Bing, the second largest search engine outside China, achieved profitability for the first time in late 2015.

The proliferation of mobile devices over the last decade has made search accessible at all times to more people, increasing usage and improving results with location data. Search queries now mostly come from mobile phones. To protect this share from disintermediation, particularly by Apple, Google released the Android mobile operating system for free to smartphone makers in 2009. Android now has a global market share of over 80%, extending and entrenching Google's position in search.

Aside from continued user and query growth, Search has multiple levers to grow. In 2015 it introduced an additional paid mobile ad unit in some highly commercial transactions. This action materially accelerated growth, despite the already massive scale of the business. Similarly, in 2016 the company announced the introduction of local ads in Maps, a software asset with over one billion monthly active users, which was until that time, largely devoid of advertising. Google is also using smartphone location data to provide advertisers with data on whether physical store visits are driven by search, thereby justifying higher prices for Google's ads.

### **Leader in machine learning and artificial intelligence**

Google has invested considerably in the rapidly advancing fields of machine learning and artificial intelligence (A.I.), in part to improve its search engine so that it provides the most relevant information or content to users. Over a billion people query Google, collectively tens of thousands of times per second on a wide variety of topics. How users interact with search results inform Google as to the relevancy of the results it showed (was the first link clicked? were multiple links clicked?). Google has developed sophisticated machine learning algorithms to use this data to optimise Google's relevancy rankings. Few companies globally have access to anything close to the scope of Google's data –they include Facebook with social search and Amazon with retail search.

Google's data, coupled with its innovation in computer science and machine learning, has helped the company stay ahead of search competitors, but the implications are much broader. These capabilities have the potential to radically improve on and augment human capabilities and analyse complex systems, for example, to improve cancer diagnosis or climate science.

One of the potential uses of A.I. include a digital personal assistant. Google's Chief Executive Officer, Sundar Pichai, has noted:

*"Looking to the future, the next big step will be for the very concept of the "device" to fade away. Over time, the computer itself—whatever its form factor—will be an intelligent assistant helping you through your day. We will move from mobile first to an AI first world."*

Digital personal assistants have a tremendous opportunity to create improved services and efficiency for users. Meanwhile, the assistant may insert itself even more seamlessly between the user and the transaction than Search does today, providing a large opportunity for the assistant owner. While the major digital platforms are now investing in their own assistants (Siri, Cortana, Alexa), Google is the clear leader in the race. At its 2016 developers' conference, Google announced Home, its voice-activated home appliance that will bring Google's digital assistant into people's living rooms. Ultimately, as Pichai predicts, digital assistants could be a key medium through which people interact with the internet and conduct transactions.

### **A collection of underappreciated call options**

Google has built a collection of adjacent businesses, many leveraging Search's assets, which have large global addressable markets.

YouTube is a video platform with over one billion monthly active users. Video content creators of all sizes can generate revenue on YouTube by showing advertising to their audiences. Google takes around a 45% share of this revenue for facilitating the advertising. Google is bringing the customisation, automation, targeting and measurability of Search to video advertising, which TV has inadequate user data to replicate. As people watch an increasing amount of video content online, YouTube has grown its share of the approximately US\$170 billion global (ex-China) video advertising market.

Aside from Search, Google monetises Android through the Google Play Store, a platform where app developers can access well over a billion Android users. Google takes a 30% share of revenue for facilitating these transactions. Google Play is leveraged to the continued growth in smartphone users and usage.

Google Cloud Platform is the company's hyperscale public cloud, which is how enterprises and developers are increasingly purchasing and managing their IT resources. Google has built the largest distributed cloud infrastructure in the world to provide its consumer services - primarily Search. It is leveraging this internal capability to compete with current leaders, Amazon's AWS and Microsoft's Azure, in this nascent market with enormous potential for high levels of growth over the long term.

Alphabet's Other Bets segment represents ventures unrelated to its internet businesses (Google) which are disruptive and could become large stand-alone companies. These include Google Fiber (US wireline internet/TV provider), Nest (home automation devices) and self-driving cars. While Other Bets represented less than 1% of Alphabet's 2015 revenue, they collectively incurred US\$4 billion in costs in 2015, representing over 15% of Alphabet's pre-tax earnings.

While many of Alphabet's businesses have entrenched market positions and massive growth opportunities, they do face several threats including government regulation, competition from Microsoft, Amazon, Apple and Facebook, together with potential disruption (e.g. competing intelligent assistants). In addition, there is a lack of transparency with respect to its Other Bets investments and its intentions regarding its large and growing cash balance.

Despite Google's history of successful and profitable innovation and its unique global assets, we believe that Alphabet's current share price materially undervalues its Search (including Maps), YouTube, Play Store, and Google Cloud Platform and incorporates no (possibly negative) value for many of its potentially massively disruptive businesses or success in achieving dramatic advances in A.I.

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